No. 6459

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MURPHY OIL COMPANY, A CORPORATION, RESPONDENT

UPON PETITION TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR PETITIONER

G. A. YOUNGQUIST,
Assistant Attorney General.

J. L. MONARCH,
JOHN G. REMEY,
J. P. JACKSON,
Special Assistants to the Attorney General.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.

R. N. McMILLAN,
J. K. POLK,
Special Attorneys,
Bureau of Internal Revenue,
Of Counsel.

INDEX

CITATIONS

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 6459

Commissioner of Internal Revenue, petitioner

v.

Murphy Oil Company, a Corporation, respondent

UPON PETITION TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR PETITIONER

PREVIOUS OPINION

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 231–247), which is reported in 15 B. T. A. 1195.

JURISDICTION

The case involves income and excess-profits taxes for the years 1919 and 1920, and this appeal is taken from an order of the Board of Tax Appeals entered January 17, 1930, which determined that there were no deficiencies in tax for the said years. (R. 253.) The case is brought to this court by petition for review filed July 11, 1930 (R. 253), pursuant to Sections 1001, 1002, and 1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109, 110.

QUESTION PRESENTED

Taxpayer leased certain oil properties, receiving therefor a cash bonus in addition to regular stipulated royalties. Did the Board of Tax Appeals err in holding that said bonus payment may not be reduced by a reasonable allowance for depletion?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, pp. 25, *infra*.

STATEMENT OF FACTS

The Board of Tax Appeals made the following findings of fact (R. 234–240):

Taxpayer corporation was organized on or about August 18, 1904, under the laws of California and has its home office at Whittier, California. It took over from Simon J. Murphy certain oil properties, among which was an oil and gas lease on certain land situated in California and owned by Domingo Bastanchury. The taxpayer, through Edmund W. Bacon, one of its officers and its agent, purchased 2,240 acres of land (hereinafter referred to as the Coyote properties) covered by such lease for

$35 per acre, or $78,400, the deed to Murphy being dated December 15, 1904, and the deed from Murphy to petitioner being dated January 9, 1905. The purchase agreement involved also a cancellation of the oil and gas lease and the leasing of the surface rights to Bastanchury for ten years for grazing purposes.

At the time Bacon purchased property, a well (hereinafter referred to as well No. 1) had been drilled to considerable depth under the lease, drilling operations had ceased, and the well had been capped. Drilling operations were resumed after the land was acquired by the taxpayer.

By an instrument dated December 1, 1913, taxpayer leased certain oil properties, known as the Whittier and Coyote Oil properties, to the Standard Oil Company of California for forty years, and by the same instrument, sold to that company specified personal property, including fixtures, appurtenances, tools, machinery, and equipment, which were at that time located on or used in connection with such oil properties. The instrument recited cash consideration of $10 (and other consideration, the receipt of which was acknowledged, which a stipulation shows to have totaled $1,500,000) and additional payments to be made from time to time. The due date, the actual date of payment, and the amount of such additional payments may be tabulated as follows:

Due date	Date paid	Amount
Apr. 30, 1914	Apr. 1, 1914	$1,000,000
Mar. 31, 1915	Mar. 1, 1915	250,000
June 30, 1915	June 1, 1915	250,000
Sept. 30, 1915	Sept. 1, 1915	250,000
Dec. 31, 1915	Dec. 31, 1915	250,000
June 30, 1916	July 13, 1916	500,000
Dec. 31, 1916	Dec. 1, 1916	500,000
Dec. 31, 1917	Dec. 1, 1917	500,000
Dec. 31, 1918	Dec. 1, 1918	500,000
Total		4,000,000

The $1,500,000 paid down brings the total of such payments to $5,500,000. Taxpayer also was to receive for the first five years a royalty of one-fourth of all oil produced in each year in excess of 730,000 barrels, and after the five-year period the royalty reserved amounted to one-fourth of the oil produced. The gas royalty agreed upon was a payment of two cents for each 1,000 cubic feet of gas saved and sold.

Of the $5,500,000 payments, the Commissioner determined that $326,404.82 represented payment for the personal properties sold and the remainder of $5,173,595.18 represented a bonus payment on the two properties. The Commissioner allocated such total bonus payment, $656,192.48 to the Whittier property and $4,517,402.70 to the Coyote property, and deducted the amount of such bonuses from the capital sums returnable through depletion in determining the unit of depletion sustained in 1919 and 1920, the years in controversy. Depletion deductions were based on March 1, 1913, value.

The gross production of the two properties in barrels of oil and the value thereof at the mouth of the wells from March 1, 1913, through the year 1915, is as follows:

During period—	Coyote		Whittier	
	Barrels	Amount	Barrels	Amount
Mar. 1, 1913, to Nov. 30, 1913	344, 094. 63	$292, 480. 44	221, 178. 85	$133, 968. 52
Dec. 1, 1913, to Dec. 31, 1913	6, 697. 47	5, 744. 52		
Calendar year 1914	151, 424. 90	127, 000. 42	5. 50	3. 30
Calendar year 1915	322, 064. 60	278, 124. 21	16, 943. 54	10, 166. 13
Total	842, 281. 60	703, 349. 59	238, 127. 89	144, 137. 95

The depletion determined by the Commissioner to have been sustained by the taxpayer from March 1, 1913, through the year 1915 is as follows:

	Period, Mar. 1, 1913, to Dec. 31, 1913	1914	1915	Total
Whittier	$74, 048. 17	$17, 738. 65	$38, 021. 95	$129, 808. 75
Coyote	183, 327. 41	135, 572. 08	306, 749. 76	625, 649. 25
Total	257, 375. 58	153, 310. 73	344, 771. 69	755, 458. 00

The Commissioner reduced taxpayer's depletable base by the above amount of $755,458 in determining the depletion allowable for the years 1919 and 1920.

The Commissioner determined that the amount of oil produced from taxpayer's share of the Coyote Oil property during the years 1919 and 1920 was 1,644,897 barrels and 1,340,237 barrels, respectively.

The Commissioner determined the oil reserves in the Coyote property at December 31 of 1918 and 1919 amounted to 5,051,424 and 3,406,527 barrels, respectively.

The Board of Tax Appeals held that the entire bonus payment was income and that any depletion allowance against such income was a departure from the depletion concept and that the Commissioner's amended regulation was invalid. (R. 246.) From this decision the Commissioner has appealed. (R. 253.)

ASSIGNMENT OF ERRORS

The Board of Tax Appeals erred (R. 256–257):

1. The Board of Tax Appeals erred in holding that cash bonus payments to the lessor by the lessee of an oil and gas lease constitute income to the lessor in their entirety, and that no part of such payments represents recovery of capital by the lessor.

2. The Board erred in holding that no part of such cash bonus payments reduces the depletable base of the lessor.

3. The Board erred in holding that the Treasury Department Regulations covering the instant subject matter are a departure from the depletion concept, and in failing and refusing to follow said regulations.

4. The Board erred in failing to find and to hold that such cash bonus payments in whole or in part

represent a return to the lessor of its capital investment.

5. The Board erred in failing to find and to hold that the depletable base of the lessor is reducible by the amount of such cash bonus payments in whole or in part.

6. The Board erred in redetermining the taxpayer's 1919 and 1920 tax liability and finding and holding that there was no deficiencies in tax for those years.

7. The Board erred in failing and refusing to approve the deficiencies in tax for 1919 and 1920 as determined by the petitioner.

8. The Board erred in its conclusions of law set forth in its opinion. Such conclusions were not responsive to its findings of fact and were contrary to and not supported by the evidence presented.

SUMMARY OF ARGUMENT

The decision of the Board of Tax Appeals in holding that cash bonuses paid in prior years as an advance royalty under an oil lease were income in their entirety and did not serve to reduce in whole or in part the basic value of taxpayer's properties returnable through depletion is erroneous. The base was proportionately recovered at the time of receipt of cash bonuses and the allowance of a current depletion deduction predicated upon the original base and not taking into consideration the prior recovery thereof means that taxpayer is permitted in the years involved here to have a second return of its capital by way of an increased depletion allowance.

The amended regulation relied upon by the Commissioner in allocating advance royalties between income and depletion allowance is a reasonable and valid interpretation of the depletion provisions of the Revenue Act. It is no departure from the depletion concept, as held by the Board. Depletion is only allowed with relation to the exhaustion of the resources, but where royalties are paid in advance of extraction, the depletion in connection therewith should also be allowed in advance. Provision is made to limit the depletion allowances by the quantity of mineral removed, and the regulation, while recognizing and adopting the true concept of depletion, merely serves to correlate the deductions with the income, thereby effecting a more reasonable and equitable result for both the taxpayer and the Government. The Board's decision operates as a distortion of income in all years of royalty payments. This result is obviated by the regulation.

ARGUMENT

The bonus payment was an advance royalty. The depletion deduction should also be taken in advance

This case involves income and profits taxes for the years 1919 and 1920. The deficiency assessed for those years depends upon the amount of depletion allowable to taxpayer as lessor of certain oil properties. Taxpayer received a cash bonus under his oil leases in addition to regular stipulated royalties, and this cash bonus, amounting to over five million dollars, was paid during the years 1913 to 1918, inclusive. The amount of depletion allowable in the current years of 1919 and 1920 depends upon the treatment of these cash bonuses. Under regulations in effect at the time the bonuses were paid, these bonus payments were considered as a return of capital so that the basic value of the taxpayer's oil rights was reduced by the amount so paid and the taxpayer paid no income tax thereon in those years. Now, however, when the question of a depletion allowance for the years 1919 and 1920 arises, the liability for the prior years being closed, the Board holds that the cash bonuses paid in those prior years constituted taxable income in their entirety and that no depletion should be allowed with respect thereto. If the Board is right, the result is that the taxpayer in this case will actually obtain a double deduction. The bonus payments in years prior to 1919, being then treated as return of capital, escaped income tax entirely.

In the years involved here the Board allows a second return of capital by way of an increased depletion deduction, holding that no part of the bonus payment reduced the depletable base in the years of payment. It is the Commissioner's position that this treatment of the bonus payment by the Board was improper and that there is properly allowable in respect of the bonus payments a reasonable deduction for depletion. If the cash bonus is not to be offset by any depletion allowance, the Board's holding under current years in this case is correct. But, if the depletion deduction is allowable with respect to the cash bonus, there is a smaller remaining depletable base in the years 1919 and 1920 and the Board has erroneously allowed too much depletion for those years. The decision of the Board of Tax Appeals that the entire cash bonus payment constituted taxable income and that no allowance may be made for depletion is predicated on the theory that no depletion allowance should be made in advance of the exhaustion of the resources. (R. 232.) It is the Government's position that the cash bonus bears a direct relation to the exhaustion of the resources and that hence the depletion allowance was properly made at the time of the receipt of the bonus. Thus the question is reduced to a determination of whether there was a recovery of base at the time of the receipt of the cash bonus in prior years which may now be disregarded and taxpayer's whole original basic value be returned to it, despite the fact that a partial return has already been made.

Under the local law of California, where the properties in this case were located, it seems clear that oil and gas, being fugacious minerals, are not owned outright by the owners of the property under which the oil and gas lie. The only right that the lessor has, as owner of the property, is the right to reduce the oil and gas to possession. *Acme Oil and Mining Co.* v. *Williams,* 140 Cal. 681; *Humphrey* v. *Buena Vista Water Co.,* 84 Pac. 296–297; *Bandini Petroleum Co.* v. *Superior Court,* 293 Pac. 899; *People* v. *Associated Oil Co.,* 294 Pac. 717.

Unlike the law in Texas, where a lease such as that involved in this case is considered an outright sale of the oil and gas in place (*Ferguson* v. *Commissioner* (C. C. A., 5th), 45 F. (2d) 573; *Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279), the lease is no more than a lease and the lessee is in no legal sense a purchaser of either the oil and gas in place or of the entire incorporeal right of the lessor to reduce the oil and gas to possession. *Alexander* v. *King* (C. C. A., 10th), 46 F. (2d) 235; *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503. The bonus was paid, therefore, not to purchase either the oil and gas in place or the lessor's entire incorporeal right, but was paid as royalty or rent. Cash bonuses are considered as advance royalties. They are just as much royalties as the stipulated regular royalties paid with relation to the production. *Work* v. *Mosier,* 261 U. S. 352, 357–358. But all royalties, the bonuses as well as the regular royalties, are considered as income derived from the use of the property and not as a return of capital on the sale of a capital asset. *Work* v. *Mosier, supra; Von Baumbach* v. *Sargent Land Co., supra; Stanton* v. *Baltic Mining Co.,* 240 U. S. 103; *Stratton's Independence* v. *Howbert,* 231 U. S. 399.

Although it is clear that such royalties are income, still it also seems equally clear that they are gross income and not net income; that is, gross income subject to the deduction authorized by Congress, *Stratton's Independence* v. *Howbert, supra; United States* v. *Biwabik Mining Co.,* 247 U. S. 116.

There is, of course, no inherent right to a depletion deduction, and, if none is provided by Congress, the entire income from operation is taxable. *Merle-Smith* v. *Commissioner* (C. C. A., 2d), 42 F. (2d) 837; *Pugh* v. *Commissioner* (C. C. A., 5th), 49 F. (2d) 76; *Stratton's Independence* v. *Howbert, supra; United States* v. *Biwabik Mining Co, supra.* Since depletion is purely a matter of statutory grant, the sole question involved in this case is one of the construction of the depletion provisions of the Revenue Act of 1918. *Burnet* v. *Thompson Oil & G. Co.,* 283 U. S. 301.

In the Revenue Act of 1918, Congress provided that in computing net income there should be allowed as a deduction from gross income in the case of oil and gas wells:

> Sec. 214(a)(10 * * * reasonable allowance for depletion * * * according to the peculiar conditions in each case, * * * such reasonable allowance * * * to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

The original ruling of the Commissioner pursuant to this provision was contained in Article 215, Regulations 45, 1920 Edition, *infra,* and was to the effect that the entire advance royalty should be applied to reduce the base and thus constitute a non-taxable return of capital if the base be as large as the bonus. On the date of the mailing of the notice of deficiency in this case, this Regulation was in force and the base was accordingly reduced by the entire amount of the bonus. Hence the taxpayer paid no taxes due to the receipt of the $5,000,000 bonus.

Subsequent to the mailing of the deficiency notice, the Commissioner amended the Regulation through the issuance of Treasury Decision 3938, C. B. V–2, p. 117. This amendment promulgated a more logical rule in view of the concept of a cash bonus as an advance royalty. It provided for a depletion deduction with respect to cash bonuses in an amount equal to that proportion of the basic value which the amount of the bonus bears to the sum of the bonuses and royalties expected to be received. At the trial of this case it was conceded that this portion of the bonus should be substituted as a depletion deduction rather than the entire amount of the bonus, but as there was a failure of proof on the part of the taxpayer to show what royalties were expected to be received under the leases, it is submitted that, if the theory of the Commissioner be sustained by this court, the deficiency as originally proposed must be affirmed since the burden of establishing error in the Commissioner's determination has not been overcome. *Botany Mills* v. *United States,* 278 U. S. 282; *Reinecke* v. *Spaldings,* 280 U. S. 227.

The issue in the case, therefore, requires a consideration of the question of the validity of the amended regulation. It would appear that this amended regulation is a reasonable interpretation of the statutory provisions cited above. In allocating the bonus payment between income and depletion deduction, the Commissioner, we submit, was carrying into effect the statutory intent of Congress. The regulation in substance merely provides that where royalties are paid in advance the depletion deduction in connection therewith should likewise be taken in advance.

It is clear that the bonus was an advance royalty. *Work* v. *Mosier, supra.* It was in direct payment of the resources to be exhausted being part of the royalty or rent paid therefor. In fixing the amount of the bonus, undoubtedly gross production was considered and the amount of the bonus was linked with the anticipated royalty receipts, so that as the bonus payment was large the unit royalty price was small. The record confirms this. The bonus payments extended over a period of five years, from December 1, 1913, to December 1, 1918. For the first five year period taxpayer's stipulated regular royalty in addition to the bonus was fixed at one-fourth of all oil produced in each year *in excess of 730,000 barrels* but after the five year period, that is after the bonus payments ceased, the royalty reserved amounted to one-fourth of the oil produced. (R. 237, 238.) Thus it seems clear that the bonus payment was directly related to the resources to be exhausted.

We are not in disagreement with the Board that the operation of the principle of depletion depends upon exhaustion of resources through production—that is, the recovery of capital through the conversion of oil resources or reserves into marketable products, or the equivalent received for such products, and that the depletion allowance can only be measured by reference to the oil produced. (R. 245–246.) We agree that the depletion deduction is dependent upon, and directly connected with, the exhaustion of the reserve, but we do contend that the bonus payment is advance royalty paid in connection with, and directly for, the mineral to be extracted. Inasmuch as the depletable mineral is paid for partly in advance, the depletion deduction should also be taken partly in advance. There is no question here of *who* has the right to take depletion, nor is there any question of the *amount* of the depletion to be allowed. This is solely a question of the *time when* the depletion should be taken.

The right to depletion is limited to those who have rights in the minerals themselves, *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364, and as to amount is limited by, and directly connected with, the extraction, *Burnet* v. *Thompson Oil & G. Co.,* *supra,* but the time for taking the depletion is the time at which the royalties are paid. That is to say, the depletion deduction must be taken at the time the income from the leased properties is received. *R. M. Waggoner et al.,* 5 B. T. A. 1191; *Inspiration Consolidated Copper Co.,* 11 B. T. A. 1425. If the royalties are anticipated, then the depletion should be anticipated. This does not mean that the depletion deduction allowed with respect to the cash bonus prior to the removal of the mineral bears no relation to the resources to be exhausted. We think that the depletion allowances are so related to the actual exhaustion of reserve that the total deductions for depletion can not in the aggregate exceed the basic value. Footnote 4, *United States* v. *Ludey,* 274 U. S. 295. The amended regulation conforms to this theory and is not a departure from the depletion concept, as the Board holds. The regulation, appendix, p. 25, *infra,* provides that:

> * * * no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

Indeed, the regulation is so inextricably interwoven with the true concept of depletion as to make provision in extraordinary circumstances for the restoration to the capital account of depletion deductions allowed in excess of the actual extraction of the minerals themselves. The regulation provides (appendix, p. 17, *infra*):

> If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed. * * *

And the regulation continues:

> Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, * * *.

It is seen, therefore, that the regulation is no departure from the depletion concept, but that the deductions are limited by, and related to, the exhaustion of the reserve. The regulation merely affords a more equitable and a more reasonable means of connecting the depletion deduction with the income received from the depletable asset. By associating the deduction with the income, the regulation obviates the distortion of income in all years in which the royalties are paid. This may be illustrated by an extreme example. We may conceive of a case in which there are 100,000 units of mineral and an outside consideration for lease proposed of $100,000. The lease might be drawn so as to provide for rental by way of bonus or lump-sum payment of $99,000 and a further unit royalty of one per cent per unit as extracted. Suppose in this case the basic cost is $80,000. Under the theory of the Board of Tax Appeals, there is income of $99,000 without any offsetting depletion deduction

In the ensuing years, and while there is an exhaustion of the resources, the Board's decision would sanction depletion deductions of $80,000 which would be offset only by royalty receipts of $1,000. This theory of the Board clearly distorts income in all years. The amended regulation would allocate the bonus payment of $99,000 between income and depletion deduction, and, as a result, would produce a taxable income which would not be distorted in any year. This practice is manifestly fairer and more equitable to both the taxpayer and the Government.

In our supposititious case, the lease might also be drawn with provisions for a bonus of $10,000 and a unit royalty of ninety cents per unit extracted. The amount of distortion, if the Board's theory be followed, would be less in that case than in the first form, but it is apparent that a distortion would nevertheless result. There is in reality no differentiation between an advance royalty and a current royalty which should permit a depletion deduction to be taken against the one and denied against the other. The bonus payment in the instant case was an advance royalty paid for the oil rights just as much as the stipulated regular royalties were paid therefor, and in all fairness to both the taxpayer and Government that species of royalty should bear its fair proportion of the depletion allowance.

The fundamental principle of treating each year separately for taxation purposes is well established, *Lucas* v. *American Code Co.,* 280 U. S. 445; *Burnet* v. *Thompson Oil & Gas Co., supra,* but this does not require a severance of related and dependent income and expense items in view of the fact that they fall in two periods. In fact, in order that one year's income might be properly reflected, expenditures producing benefits extending into other years are required to be deducted over that period of benefit. *Duffy* v. *Central R. R.,* 268 U. S. 58; *Galatoire Bros.* v. *Lines* (C. C. A. 5th), 23 F. (2d) 676. The regulation, in correlating the depletion deduction with the income received, does not establish an entirely novel practice. Frequently, the expenses and cost of producing income are permitted to be deducted against such income in computing net income, regardless of divergencies in periods of incidences. Thus the accrual method of accounting authorized by the statute "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period the expenses incurred in and properly attributable to the process of earning income during that period." *United States* v. *Anderson,* 269 U. S. 428; *American National Co.* v. *United States,* 274 U. S. 99. Likewise, where bonds are sold at a discount a taxpayer is permitted to amortize such discount over the life of the bonds, thus absorbing the loss which will be sustained, if the bonds are ultimately retired at par. *C., R. I. & P. Railway Co.,* 13 B. T. A. 988; affirmed (C. C. A., 7th), 47 F. (2d) 990; certiorari denied October 12, 1931, No. 78 Supreme Court—October, 1931, term. Likewise, where bonds are issued by a corporation at a premium, the net amount of such premium is treated as gain or income which will be prorated or amortized over the life of the bond. *Commissioner* v. *Old Colony R. Co.* (C. C. A., 1st), 50 F. (2d) 896. Broker's fee paid for negotiating an annuity contract is considered as a capital expenditure to be added to the cost of the annuity rather than a business expense for the year when paid. The situation is similar when a lease is made.

In order to reflect clearly annual income, broker's fees paid to secure a lease should be spread over the term of the lease rather than charged against the first year's income. *Bonwit Teller & Co.* v. *Commissioner* (C. C. A., 2d), decided August, 1931, not yet reported but see C. C. H. Tax Service, 1931, Section 9535. Likewise where a lessor pays a bonus or advance rental, the payments should not be deducted in their entirety in the years of payment but should be spread over the years during which the lease is to continue. *Baton Coal Co.* v. *Commissioner* (C. C. A., 3d), 51 F. (2d) 469. Provision is made in the Revenue Acts for the use of inventories in order that the costs of merchandise may be offset against the income derived in subsequent year sales. Rentals and insurance premium paid in advance are deductible over the periods of benefit. Cf. *United Profit-Sharing Corp.* v. *United States,* 66 Ct. Cl. 171; *Commissioner* v. *Old Dominion S. S. Co.* (C. C. A., 2d), 47 F. (2d) 148. Depreciation—a return of cost or base over income productive life; and depletion—a similar deduction in respect of a different capital investment, correlate the expense with the income. The Regulations promulgated by the executive department charged with the administration of the Revenue Act make a similar provision for depletion deductions against the income derived from the depletable asset—*both in the case of unit royalty receipts and in the case of lump sum bonuses or advance royalties.* This is certainly a reasonable regulation. The decision of the Board of Tax Appeals in overturning the regulation would distort income in all years, and is unreasonable and antagonistic to the remainder of the Revenue Act and Regulations. We submit the

Commissioner's regulation is a reasonable interpretation of the statute and is in harmony with the other provisions of the Revenue Act and Regulations.

The Revenue Act of 1928 was passed after the amendment contained in T. D. 3938 had been promulgated by the Department. The present Regulations are in conformity with T. D. 3938. It is submitted that the re-enactment of the provisions of the Revenue Act dealing with depletion, without substantial change, is a Congressional recognition and adoption of such Regulations. It has been a long-established rule that reasonable regulations promulgated by administrative officials have the force of law. *Brewster* v. *Gage,* 280 U. S. 327; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349

It is believed that the regulations are reasonable and practical, and that if the decision of the Board of Tax Appeals is followed, it will produce inconvenience and result in inequality.

Moreover, as indicated above, taxpayer has had a return of its capital. The record shows that the Commissioner deducted from the capital sum returnable through depletion of taxpayer's property the amount of $5,173,595.18 representing the bonus payments. (R. 44, 45.) This treatment of the bonus payments in the prior years as a nontaxable return of capital in their entirety was due to the fact that the original regulation was not amended until 1926 and after the returns for the prior years had been filed and audited. The Commissioner at the Board trial in this case confessed error as to this treatment in the prior years and showed a willingness to adjust the depletion base in accord with the amended regulation but was unable to do so because there was nothing in the record to show what royalties were expected to be received over the lives of the leases. (R. 244, 245.) The fact that taxpayer has had its return of capital to the extent of the bonus payment should preclude it from taking a second deduction in 1919 and 1920 in the form of a depletion allowance. As was held in *United States* v. *Ludey, supra,* the deductions for depletion can not in the aggregate exceed the basic value. The fact that the bonus payments were not taxed when received on the principle that they constituted a return of capital should preclude their being retroactively treated in these years as income in their entirety. The tax liability in the former years being closed and the statute of limitations having run an upholding of the Board's decision would work a manifest inequity upon the Government.

We submit that the regulations of the Commissioner properly interpret the law and provide the proper depletion deduction and further that even if the regulations be considered invalid still the taxpayer should not have this second return of capital by way of the increased depletion allowance.

CONCLUSION

It is respectfully submitted that the decision of the Board of Tax Appeals should be reversed.

Respectfully,

G. A. Youngquist,
Assistant Attorney General.
J. L. Monarch,
John G. Remey,
J. P. Jackson,
Special Assistants to the Attorney General.
C. M. Charest,
General Counsel,
Bureau of Internal Revenue,
R. N. McMillan,
J. K. Polk,
Special Attorneys,
Bureau of Internal Revenue,
Of Counsel.

APPENDIX

Revenue Act of 1918, c. 18, 40 Stat. 1057:

SEC. 214. (*a*) That in computing net income there shall be allowed as deductions:

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *.

Treasury Regulations 45 (1920 Edition):

ART. 215. *Depletion—Adjustments of accounts on bonus or advanced royalty.*—(*a*) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

(*b*) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(*c*) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(*d*) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned.

Article 215 of Regulations 62 and Article 216 of Regulations 65 are substantially the same.

T. D. 3938, C. B. V–2, p. 117–118:

Article 215 of Regulations 45 (1920 edition), article 215 of Regulations 62, and article 216 of Regulations 65 are hereby amended to read as follows:

"Art. 216 (215). *Depletion—Adjustments of accounts based on bonus or ad-*

vanced royalty.—(*a*) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

"(*b*) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

"(*c*) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses and the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deduction made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property reposses, and the tax thereon paid.

"(*d*) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

All rulings inconsistent herewith are hereby revoked.

This Treasury Decision appears as Article 216 of Regulations 69 and Article 236 of Regulations 74.

U. S. GOVERNMENT PRINTING OFFICE: 1931